

LIUC – Università Carlo Cattaneo

International Tax Law

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*Business profits and attribution of
profits to PE*

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ART. 7 OECD MC

Art. 7 OECD MC

- The OECD MC distinguishes between several types of **business income**.
- The majority of these business income are covered by **specific articles** of the MC.
- Art. 7 OECD MC applies to business profits that are not covered by a more specific article.

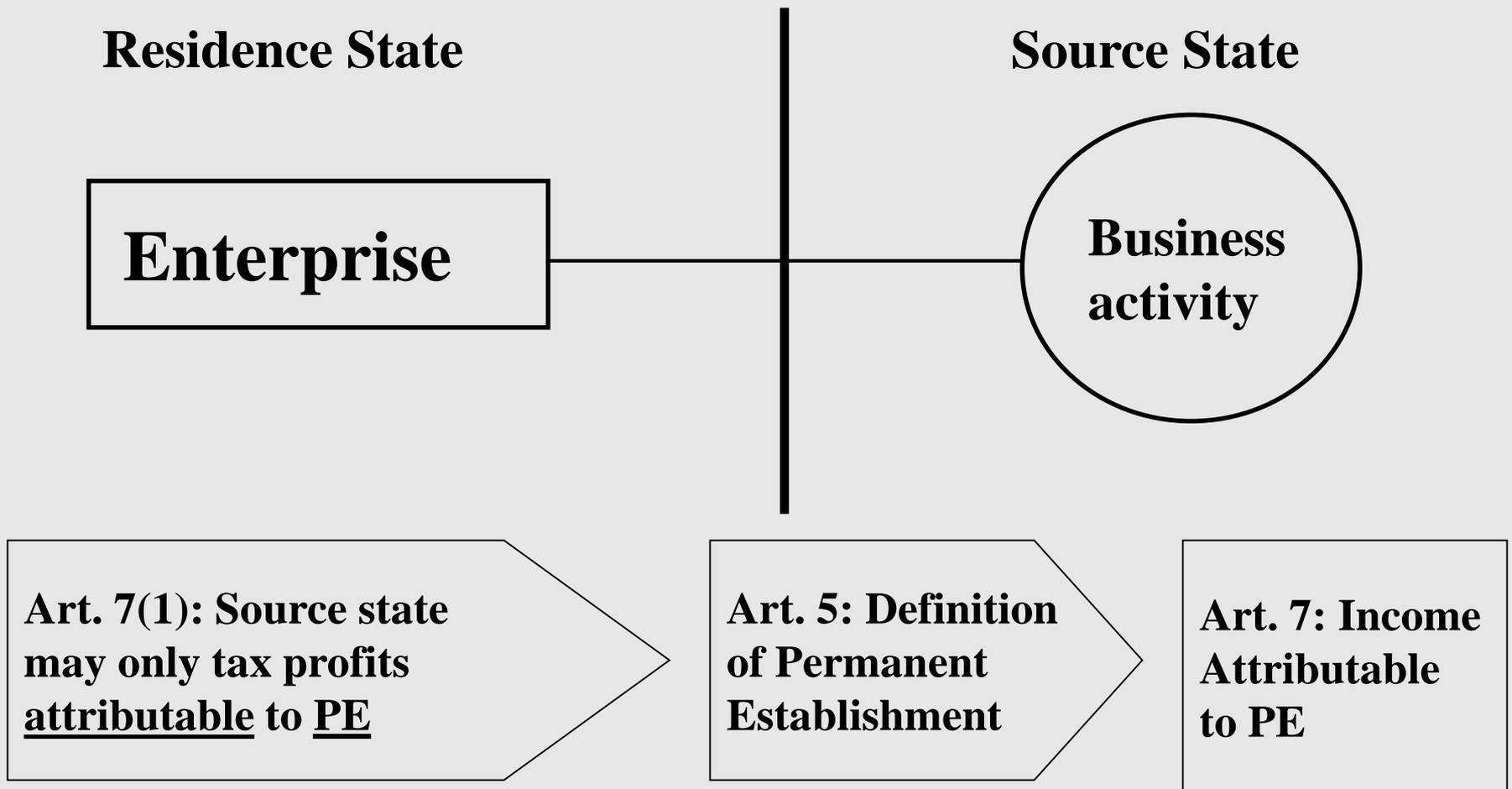
Art. 7 OECD MC

- This article may be interpreted as a **continuation to Art. 5**, which provides the definition of permanent establishment.
- The definition of permanent establishment is used in double tax treaties to determine whether a specific item of income has to be taxed in the of its source.
- However, such criterion does not provide a complete solution to double taxation. For this purpose, it has been necessary to complete the definition of permanent establishment with specific rules that determine the **income generated by permanent establishments**.

Art. 7 OECD MC

- If an enterprise of a Contracting State carries out a business activity in the other Contracting State two questions arises:
 1. **Does the enterprise have a PE in the other Contracting State?**
 2. **If the answer is yes, which item of income generated by the PE is taxable in the other contracting State?**
- The rules to apply in order to answer to these questions are set forth in Art. 7 OECD MC.

Art. 7 OECD MC



Art. 7 OECD MC

Article 7

Business Profits

- (1). *Profits of an enterprise of a Contracting State shall be taxable only in that State unless **the enterprise carries on business** in the other Contracting State **through a permanent establishment** situated therein. If the enterprise carries on business as aforesaid, the **profits that are attributable to the permanent establishment** in accordance with the provisions of paragraph 2 **may be taxed in that other State***
- (2) [...] *the **profits that are attributable** in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its **dealings with other parts of the enterprise**, if it were a separate and **independent enterprise** engaged in the **same or similar activities** under the same or similar conditions, taking into account the **functions performed, assets used** and **risks assumed** by the enterprise through the permanent establishment and through the other parts of the enterprise.*

Art. 7 OECD MC

Article 7

Business Profits

(3) “Where, in accordance with paragraph 2, a Contracting State **adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States** and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an **appropriate adjustment to the amount of the tax charged on those profits**. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other”.

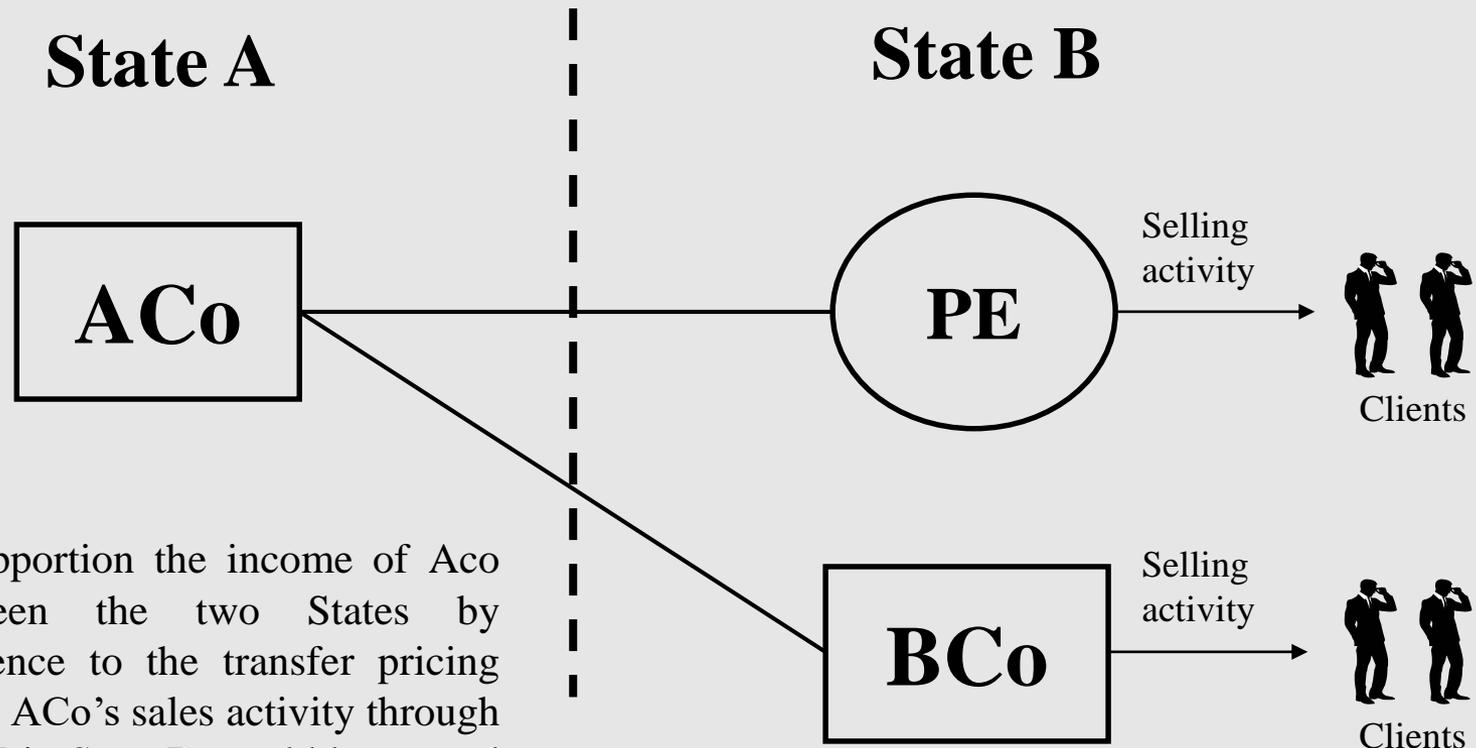
Art. 7 OECD MC

- If an enterprise of a Contracting State has a PE in the other Contracting State, it is taxable by the other State **only** on the profits attributable to the PE.
- Art. 7(2) provides that the profits of a PE should be determined on the assumption that the PE is a **separate entity** dealing independently with the other parts of the enterprise of which the PE is a part.
- The effect of the assumptions in Art. 7(2) is that the transfer pricing rules applicable to associated enterprises also apply, by analogy, for the purposes of determining the profits attributable to a PE.

Functionally separate entity approach

- Art. 7(2): application of **Arm's length principle**, so also taxation of notional profits is possible.
- Where an enterprise of a Contracting State carries on business in another Contracting State through a PE situated therein, Contracting States have to attribute to that PE the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.
- Therefore, in order to apply transfer pricing rules to PE, it is necessary to treat a PE as if it were a separate legal entity and to construct some hypothetical transactions between the PE and the foreign enterprise.

Functionally separate entity approach



To apportion the income of ACo between the two States by reference to the transfer pricing rules, ACo's sales activity through its PE in State B would be treated as if it was carried on by a subsidiary resident in State B (BCo)

Art. 7(4) OECD MC

“Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article”.

Priority is given to other Articles, Except:

- **Art. 10(4)**
- **Art. 11(5)**
- **Art. 21(2)**

**ATTRIBUTION OF PROFITS
TO PERMANENT
ESTABLISHMENT**

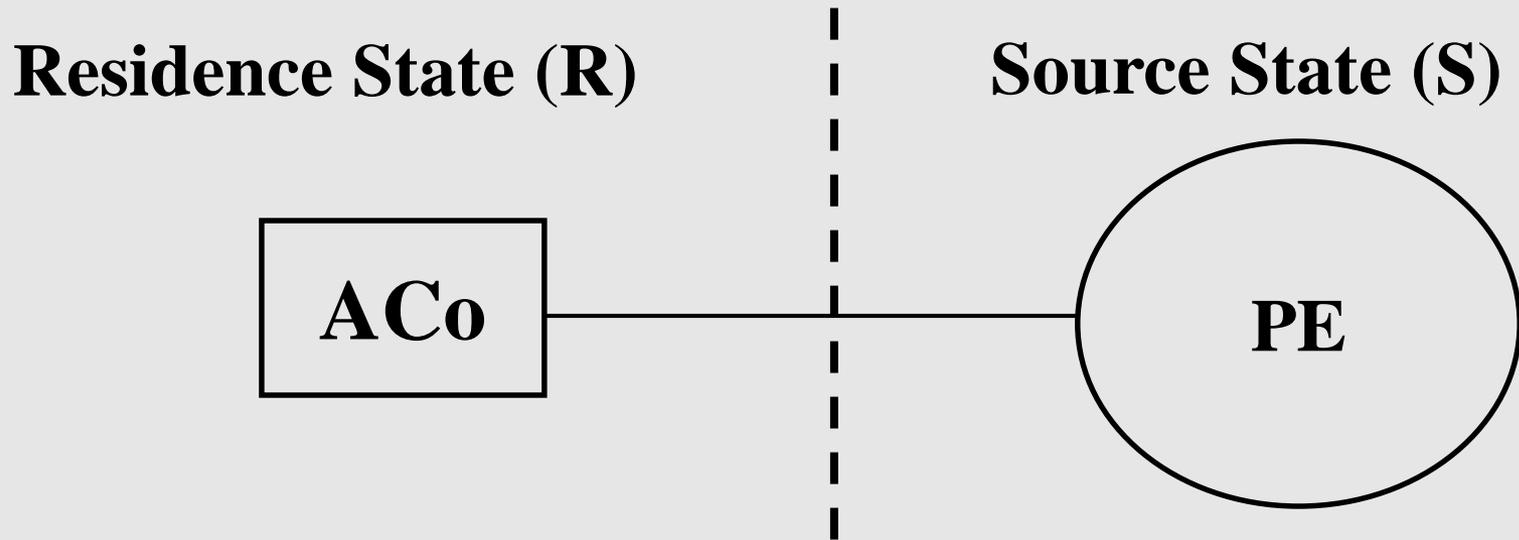
Why is profit allocation to a PE important?

- Business profits is the most important category of income for international (and domestic) tax purposes
- It determines the extent of **Source State's taxing rights** by reference to:
 - Nature of income
 - Quantity of income
- It determines amount/limit of **Double Taxation relief in Residence State**

International legal framework

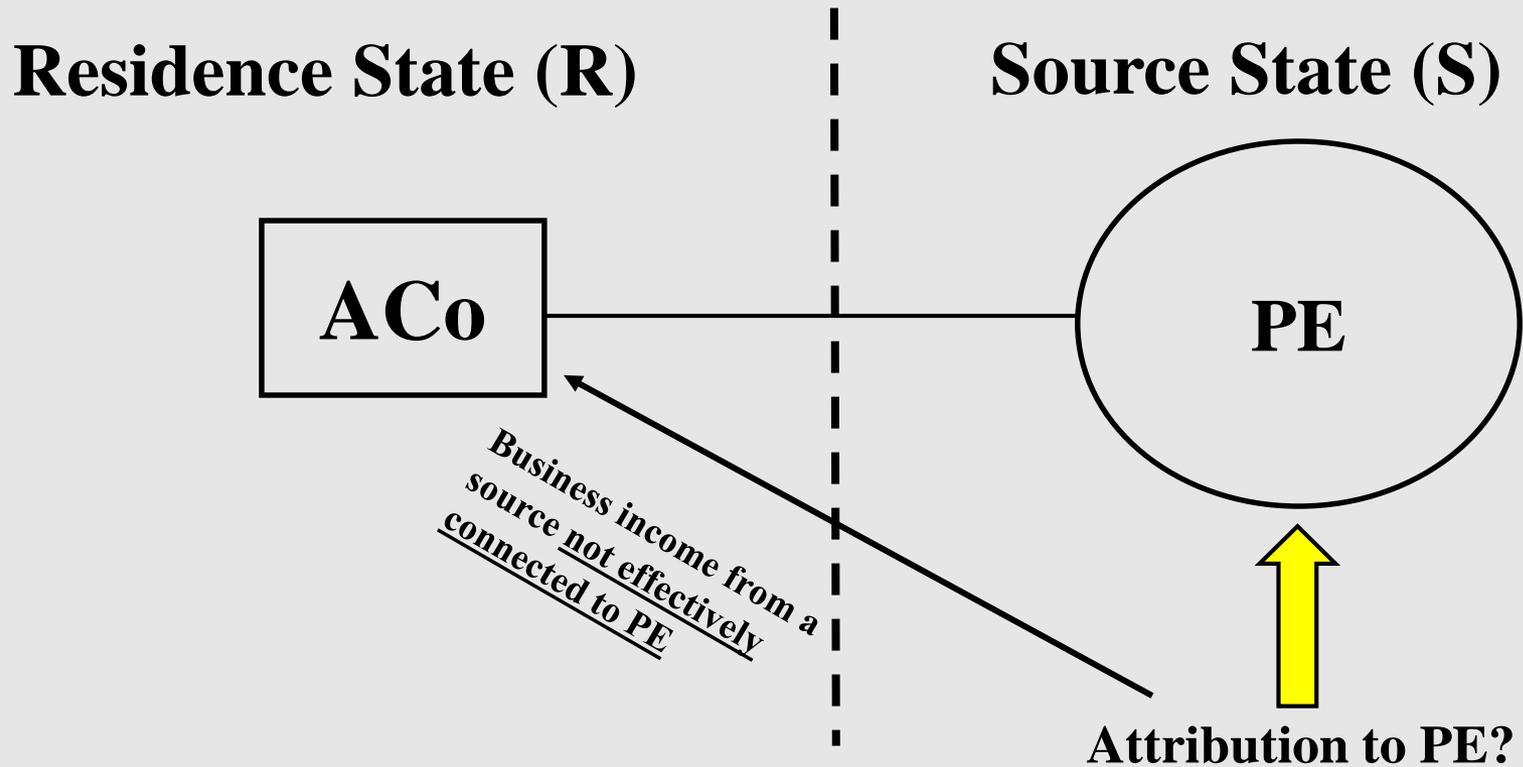
- **International Legal framework:**
 - Article 7 of the OECD MC;
 - Article 7 of the OECD MC Commentary;
 - OECD, *Report on the Attribution of Profits to Permanent Establishments* (2010)
 - *BEPS Discussion Drafts on the Attribution of Profits to Permanent Establishments* (2016/2017)

The Issue



- ACo performs business activities in state R and in state S through its PE
- Which share of the overall profits recorded by ACo should be attributed to the PE?

Force of Attraction principle – OECD vs. UN



Force of Attraction principle – OECD vs. UN

- Art. 7 of the OECD MC does not use a so-called **Force of Attraction approach**, under which all of a taxpayer's income derived from a country is subject to tax by that country if it has a PE in that country.
- Under Art. 7 of the OECD MC, if a taxpayer has a PE in a State, only the taxpayer's profits from the business that are **attributable** to the PE are subject to tax by that State.

VS.

- Article 7(1) of the UN MC employs a **limited Force of Attraction principle** in determining the income attributable to a PE.
- Under that principle, if an enterprise has a PE in a contracting State, it is taxable by that State not only on the profits attributable to the PE, but also on profits derived from sales in that State of goods similar to those sold through the PE.

Force of Attraction principle – OECD vs. UN

Art. 7(1) UN MC: *«The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to*

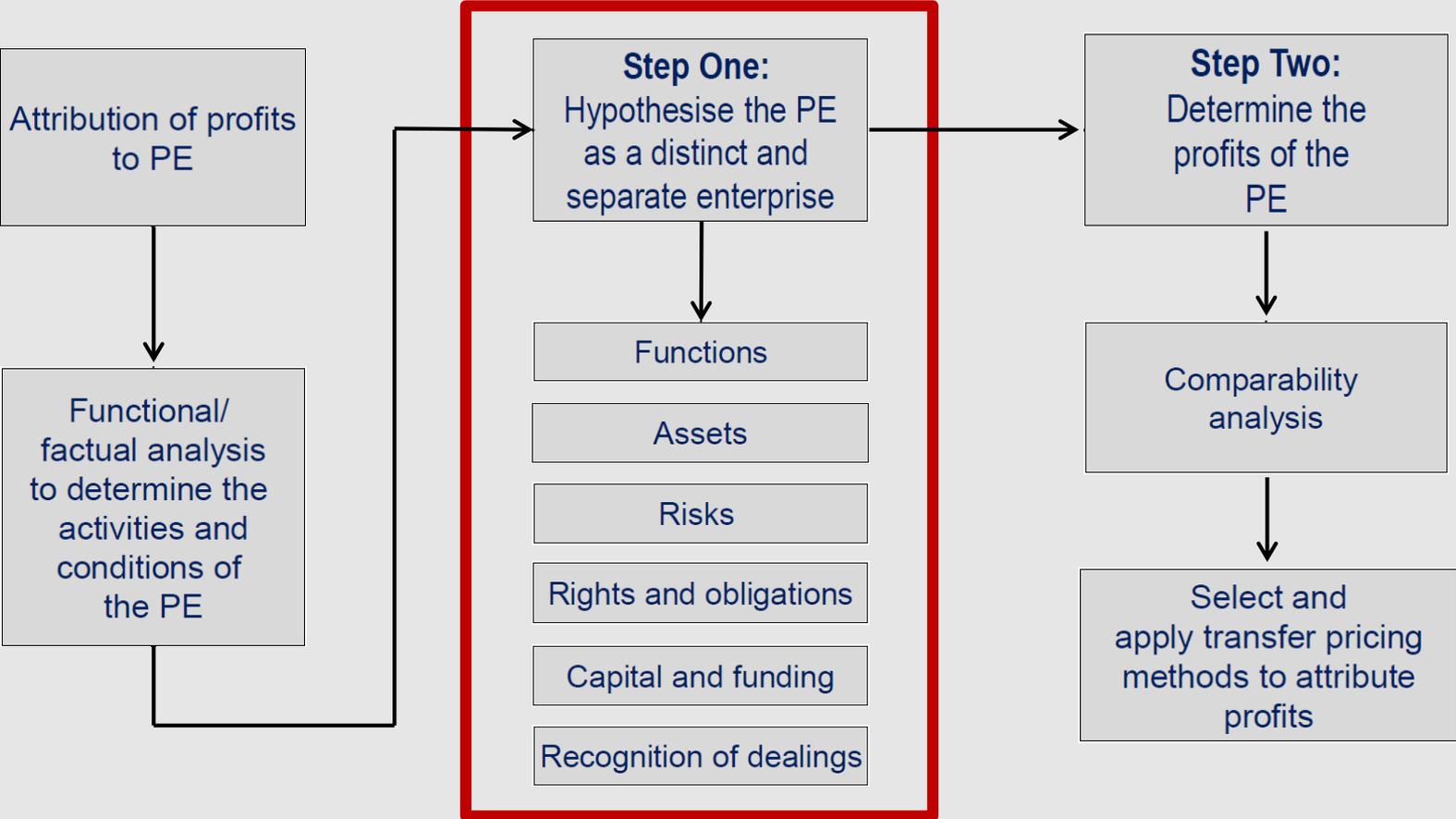
- a) that permanent establishment;*
- b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or*
- c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment».*

**AUTHORIZED OECD
APPROACH (AOA)**

Authorized OECD Approach

- Article 7 currently reflects the Authorised OECD Approach (AOA) developed in the OECD Report on the Attribution of Profits to Permanent Establishments (2010)
- Under the AOA profits to be attributed to a PE are those that the PE might be expected to make if it were
 - A separate and independent enterprise
 - Engaged in the same or similar activities under the same or similar conditions
 - Taking into account the functions performed, the assets used, and the risks assumed through the PE and through other parts of the enterprise
- The AOA requires a **two-step analysis**
 1. Performance of a functional and factual analysis in order to hypothesise the PE as separate and independent entity
 2. Remuneration of the internal dealings with the rest of the enterprise of which the PE is a part at arm's length, by applying by analogy the transfer pricing tools enshrined in Article 9 of the OECD Model

Authorized OECD Approach



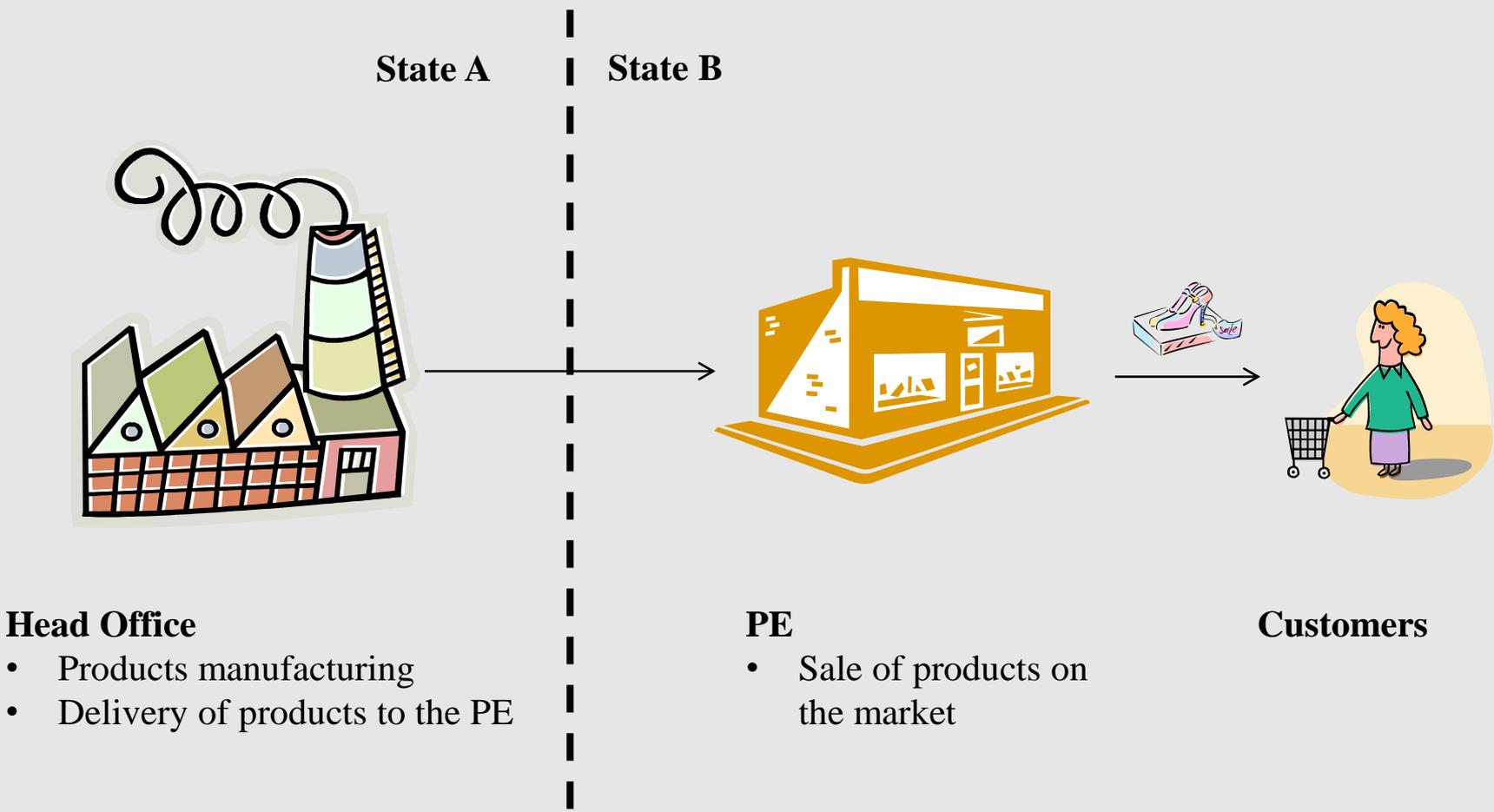
Authorized OECD Approach

Step One - Functions

- The analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the enterprise as a whole and by the enterprise through the PE for the purpose of hypothesizing the PE as a separate and independent enterprise
 - Which functions are performed by the personnel (“people functions”) of the enterprise as a whole?
 - Which people functions are performed in the PE’s premises?
 - What significance do these functions have in generating the profits of the business?
- “*People functions*” can range from support or ancillary functions to significant functions relevant to the attribution of economic ownership of assets and/or the assumption of risks

Authorized OECD Approach

Step One – PE acting as distributor



Authorized OECD Approach

Step One – Functions

- What are the economically relevant characteristics of the production/distribution functions (e.g. business strategy, decisions regarding product to be manufactured, inventory management, etc.)?
- Where are the significant people functions performed (i.e., Head Office and/or PE)?
- What activities do other parts of the enterprise perform on behalf of the PE?
- What activities does the PE perform on behalf of other parts of the enterprise?

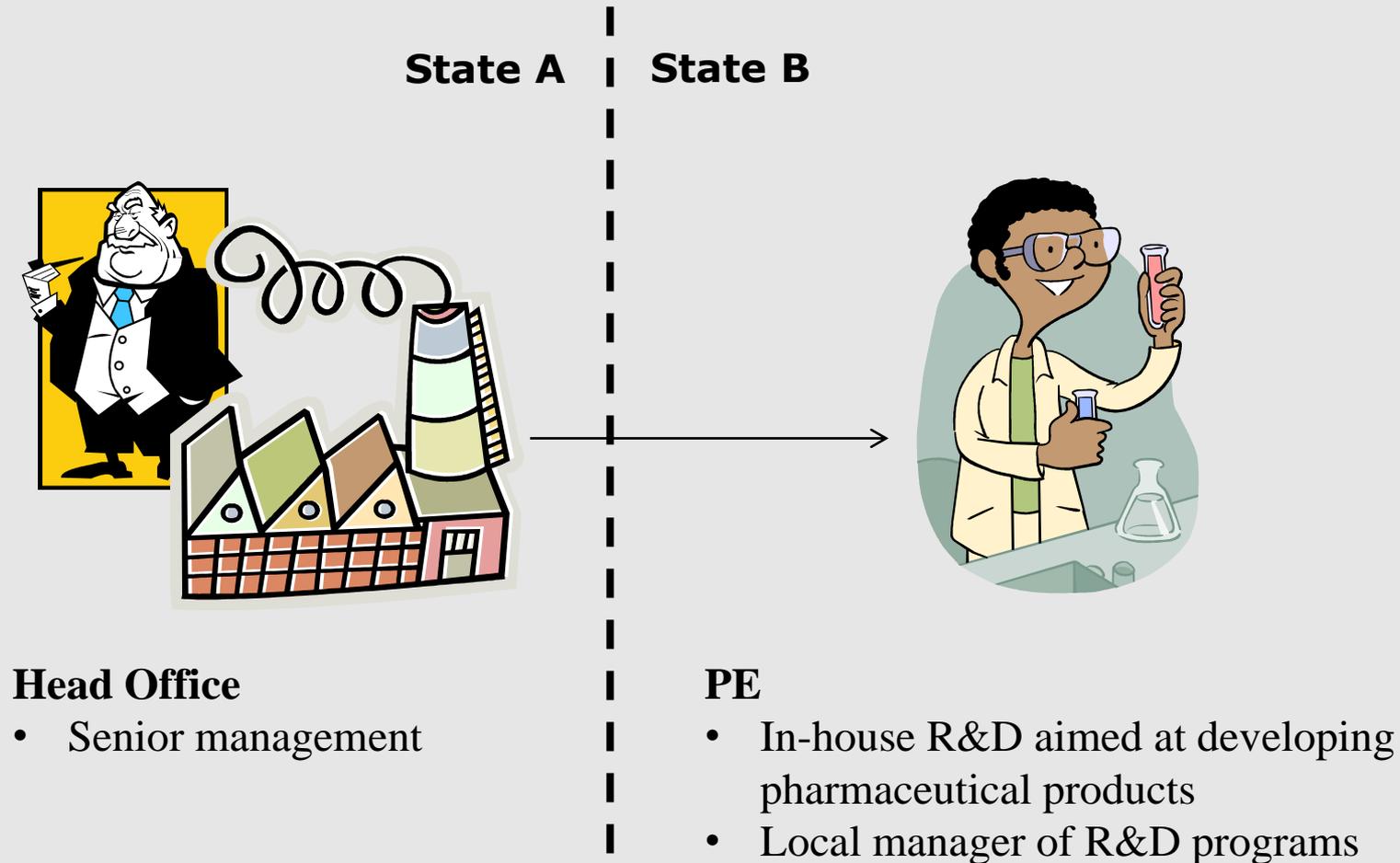
Authorized OECD Approach

Step One – Assets

- The functional analysis has to determine:
 - The extent to which assets of the enterprise are economically owned by and/or used by the PE
 - The conditions under which those assets are used by the PE (e.g. as joint or sole owner, licensee, member of a cost contribution agreement)
- Economic ownership lies upon the performance of significant people functions relevant to the assumption of risks
- Tangible assets:
 - Broad consensus to generally take into account the “use” as a basis for attributing economic ownership (pragmatic solution)
- Intangible assets:
 - Key issues which require an in-depth case-by-case analysis:
 - Which part(s) of the enterprise is(are) the economic owner of intangible property?
 - What is the impact of intangible property on profits generated by the enterprise as a whole and by the PE?

Authorized OECD Approach

Step One – R&D Example



Authorized OECD Approach

Step One – Attribution of Assets

- Should the PE be deemed the economic owner of the IP developed?
 - Where does the active decision-making with respect to the R&D programs occur?
 - What is the role of senior management with respect to the R&D programs?
 - Does senior management simply say yes or no to the proposals of the programs' local manager?
 - Who designs the testing specifications and processes within which the R&D is conducted?
 - Who reviews and evaluates the data produced by these tests?
 - Who sets the program milestones at which key decisions are taken?
 - Who takes the decisions at these milestones on whether to commit further resources to (or to abandon) the R&D project?

Authorized OECD Approach

Step One – Risks

- Risks cannot be attributed to the PE on basis of contractual arrangements because it is the enterprise as a whole that legally bears all the risks
- Under the AOA, risks are attributable to the PE to the extent that the significant people functions relevant to the assumption of those risks are performed by its personnel at its premises
 - The Significant people functions are those involved in the active decision making with regard to the assumption of the risks
 - To the extent that risks are assumed by the enterprise as a result of significant people functions performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE (i.e. attribution of extra-profits or losses)

Authorized OECD Approach

Step One –Rights and Obligations

- Identification of the transactions performed by the enterprise with separate entities which should be hypothesized as being entered into by the PE according to the functions performed, the assets used and the risks assumed
- The PE's profits (or losses) related to those transactions can be computed
 - Directly (in the case of transactions with unrelated enterprises); or
 - Through the application of the TPG by analogy (in the case of transactions with related enterprises)

Authorized OECD Approach

Step One – Capital

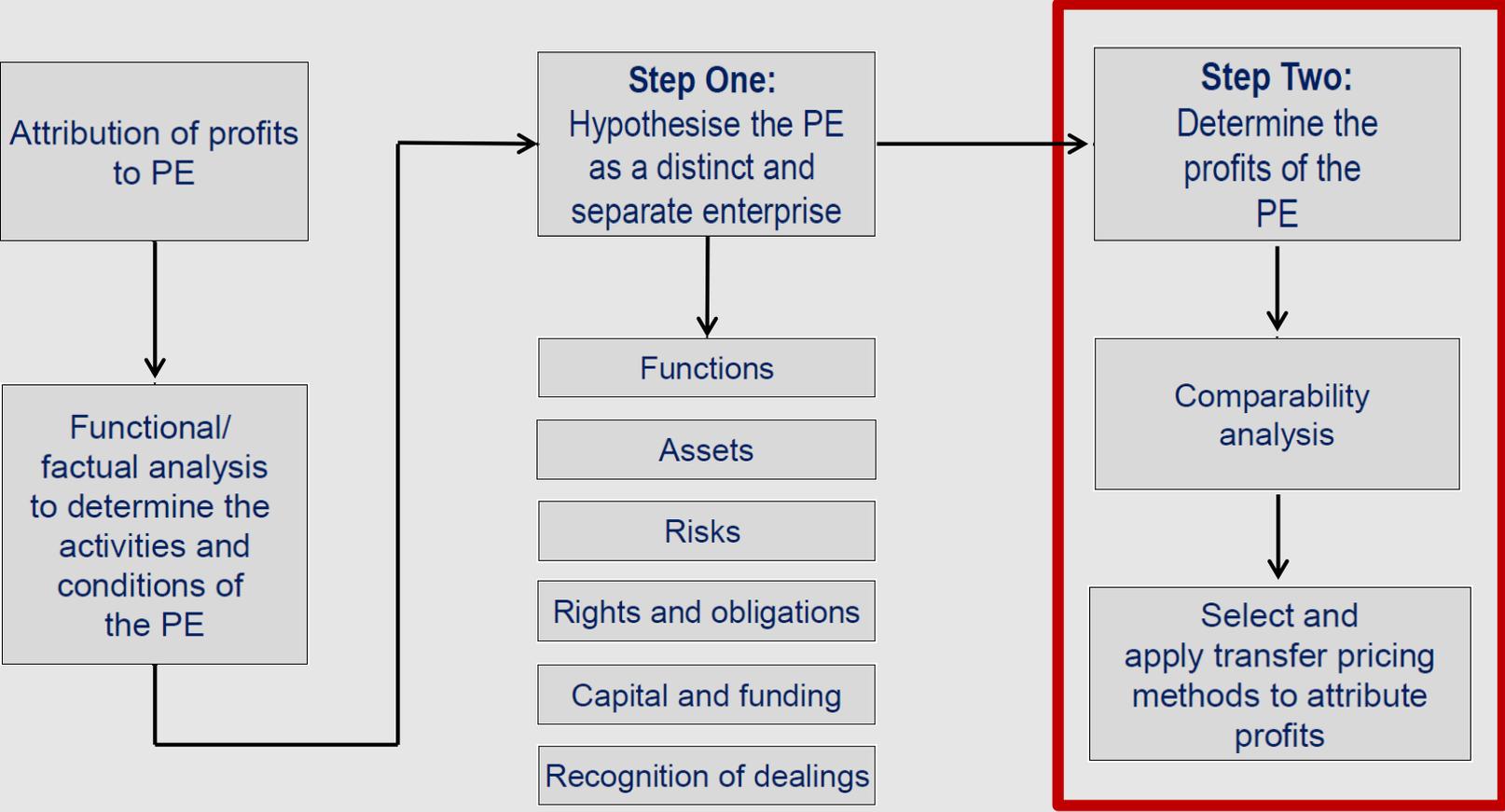
- **“Free” capital:** *an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes under the rules of the host country of the PE*
- The AOA requires that, **for tax purposes only**, an appropriate portion of the enterprise’s “free” capital be “fictitiously” attributed to its PE according to the functions performed, the risks assumed and the assets used by the PE
- Different approaches to determine the “free” capital:
 - **Capital allocation** (allocation based on proportion of assets and risks attributed to the PE)
 - **Thin capitalization** (PE attributed same amount of “free” capital as independent enterprise performing same or similar activities under same or similar conditions)
 - **Other methods** (insurance sector)

Authorized OECD Approach

Step One – Recognition of dealings

- Hypothesizing the PE as a separate entity requires identifying and determining the nature of the PE's dealings with the rest of the enterprise of which it is a part
- A dealing will be recognised if it concerns with a real and identifiable event, *i.e.* an economically significant transfer of risks, responsibilities and benefits
 - Functional and factual analysis
 - Application by analogy the guidance in Chapter 1 of the TPG on contractual terms
- Starting point: accounting records and internal documentation –analogous to contractual terms of transactions
- Taxpayers are encouraged to document their dealings

Authorized OECD Approach



Authorized OECD Approach

Step Two

- Compare dealings between the PE and the enterprise of which it is a part with uncontrolled transactions
 - Application of the comparability analysis enshrined in the TPG by analogy
 - Comparability: none of the differences (if any) between the dealing and the transaction materially should affect the measure used to attribute profits to the PE, or reasonably accurate adjustments can be made to eliminate the material effects of those differences

Authorized OECD Approach

Step Two

- Determination of the arm's length remuneration of the Internal Dealings by selecting the most appropriate method to the circumstances of the case applying by analogy the TPG
- No double-counting: to the extent that another part of the enterprise has incurred costs related to a dealing with the PE and those costs have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE
- It may be necessary to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length